

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT

Montana State Lottery

June 30, 2005 and 2004

05C-02

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**GALUSHA
HIGGINS &
GALUSHA**

A PROFESSIONAL CORPORATION OF
CERTIFIED PUBLIC ACCOUNTANTS

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Montana State Lottery

June 30, 2005 and 2004

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LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel



Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

October 2005

The Legislative Audit Committee
of the Montana State Legislature:

Enclosed is the report on the financial audit of the Montana Lottery for the fiscal year ended June 30, 2005.

The audit was conducted by Galusha, Higgins, & Galusha, PC, under a contract between the firm and our office. There are no recommendations in this report.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Scott A. Seacat", with a long horizontal flourish extending to the right.

Scott A. Seacat
Legislative Auditor

05C-02

Montana State Lottery
COMMISSION MEMBERS AND ADMINISTRATIVE OFFICIALS
June 30, 2005

COMMISSION MEMBERS

Robert Crippen, Chairperson

Wilbur Rehmann

Craig Anderson

Tom Keegan

Betty Wilkins

RESIDENCE

Butte

Helena

Glendive

Helena

Missoula

ADMINISTRATIVE OFFICIALS

George Parisot, Montana State Lottery Director

John Tarr, Montana State Lottery Director of Security

Montana State Lottery
INTRODUCTION AND BACKGROUND
June 30, 2005

INTRODUCTION

The purpose of our contract with the State of Montana and Montana State Lottery was to conduct a financial-compliance audit of the Montana State Lottery's financial statements and issue an opinion on such. The scope of our services is defined in our contract with the Office of the Legislative Auditor, dated April 21, 2005, and as supplemented by certain requirements included in the bidder information.

As a result of our audit, we have also issued a report on compliance and on internal control structure over financial reporting based on our audit of the financial statements performed in accordance with *Government Auditing Standards*.

BACKGROUND

The Montana State Lottery was created in November 1986 by a referendum vote of the people of Montana. The "Montana State Lottery Act of 1985" appears as Chapter 669 of the Montana Session Laws and Title 23, Chapter 7, of the Montana Code Annotated. The general purpose is to allow lottery games in which players purchase from the State, through the administration of the Montana State Lottery, a chance to win a prize. Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The Montana State Lottery is required to transfer its net revenue to the Montana State General Fund.

INDEPENDENT AUDITORS' REPORT

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the accompanying financial statements of the Montana State Lottery (the Lottery), an enterprise fund of the State of Montana, as of and for the years ended June 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

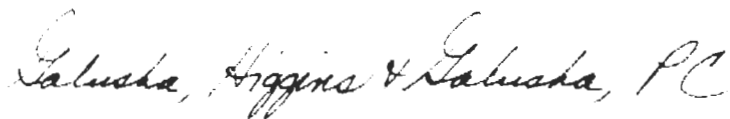
As discussed in Note A, the financial statements present only the Lottery and are not intended to present the financial position of the State of Montana and the results of its operations and cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery, an enterprise fund of the State of Montana, as of June 30, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 7, 2005 on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

To the Commissioners
Montana State Lottery

Management's Discussion and Analysis on pages 6 through 10 are not a required part of the basic financial statements but are supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in cursive script that reads "Galusha, Higgins & Galusha, PC".

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
October 7, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following *Management Discussion and Analysis* (MD&A) of the Montana State Lottery's (the Lottery) activities and financial performance provides the reader with an introduction to and overview of the financial statements for the fiscal years ended June 30, 2005 and 2004. We encourage readers to consider this information in conjunction with the financial statements, which directly follow.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Lottery is classified as a special-purpose government fund engaged only in business-type activities. Accordingly, the Lottery operates in much the same manner as commercial enterprises using the full accrual method of accounting in accordance with accounting principles generally accepted in the United States of America. The basic financial statements consist of two components:

- 1) Three Fund Financial Statements: a *Statement of Fund Net Assets*, a *Statement of Revenues, Expenses, and Changes in Fund Net Assets*, and a *Statement of Cash Flows*; and
- 2) Notes to the Financial Statements.

The *Statements of Fund Net Assets* provides information about the nature and amounts included in both short-term and long-term assets and liabilities at the end of the year. Long-term fixed assets are capitalized and depreciated over their useful lives. Because the Lottery is required to transfer all "profits", or the excess of assets over liabilities, to the State's General Fund, its "net assets" will always be zero.

The *Statements of Revenues, Expenses, and Changes in Fund Net Assets* includes all of the current years' revenues and expenses. Revenues are recognized when earned and become measurable, not when they are received. Expenses are recognized when incurred, not when paid. This statement measures the success of the Lottery's operations over the past two years and details the total amount transferred to the General Fund.

The final statement is the *Statements of Cash Flows*. The primary purpose is to provide information about the cash receipts and payments during the reporting period. The statement also reports changes in cash resulting from operations, investing and financial activities, and provides answers to such questions as where did cash come from and what cash was used for.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

NET ASSETS

The table below presents a summary of the Lottery's *Statements of Fund Net Assets*.

Condensed Statements of Fund Net Assets as of June 30, 2005 and 2004

	2005	2004	Dollar Change	Percentage Change
Current Assets	\$ 2,821,842	\$ 2,499,205	\$ 322,637	12.9%
Capital Assets (Net of Depreciation)	867,271	1,921,498	(1,054,227)	-54.9%
Other Assets	1,326,136	1,325,275	861	0.1%
Total Assets	\$ 5,015,249	\$ 5,745,978	\$ (730,729)	-12.7%
Current Liabilities	\$ 3,694,345	\$ 4,384,114	\$ (689,769)	-15.7%
Long-Term Liabilities	1,320,904	1,361,864	(40,960)	-3.0%
Total Liabilities	\$ 5,015,249	\$ 5,745,978	\$ (730,729)	-12.7%
Invested in Capital Assets, Net of Related Debt	\$ 867,271	\$ 1,921,498	\$ (1,054,227)	-54.9%
Unrestricted Fund Net Assets	(867,271)	(1,921,498)	(1,054,227)	-54.9%
TOTAL FUND NET ASSETS	\$ 0	\$ 0	\$ 0	0

The largest changes in Current Assets are a \$200 thousand increase in Accounts Receivable due to timing in our collections process and a \$67 thousand increase in premium inventory. The \$1 million decrease in Capital Assets is due to depreciation on the lottery operating system and amortization of the software associated with that system.

The major changes in Current Liabilities are a \$664 thousand decrease in the amount due to the General Fund as a result of operations, and a decrease in prize liability of \$100 thousand. There were moderate increases in Accounts Payable of \$51 thousand and Deferred Revenue of \$37 thousand due to timing. Long-Term Liabilities remained mostly unchanged but did have small decreases due to changes in Employee Compensated Absences and prize reserves held by the Multi-State Lottery Organization.

The category, *Invested in Capital Assets, Net of Related Debt*, consists of capital assets less accumulated depreciation, amortization and the outstanding balance on the debt related to the purchase of these assets, if any. Since the Lottery is required to transfer the total results of operations to the General Fund, the Net Assets should always be \$-0- and the Unrestricted category is just a balancing figure.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

OPERATIONS AND CHANGES IN FUND NET ASSETS

The table below presents a summary of the Lottery's Operations for the last two years.

Condensed Statements of Revenues, Expenses and Changes in Fund Net Assets For the Years Ended June 30, 2005 and 2004

	2005	2004	Dollar Change	Percentage Change
Operating Revenues	\$ 33,842,650	\$ 36,740,200	\$ (2,897,550)	-7.9%
Direct Game Costs	(23,358,777)	(24,541,603)	1,182,826	-4.8%
Net Operating Revenue	\$ 10,483,873	\$ 12,198,597	\$ (1,714,724)	-14.1%
Operating Expenses	(4,321,626)	(4,095,972)	(225,654)	5.5%
Net Operating Income	\$ 6,162,247	\$ 8,102,625	\$ (1,940,378)	-24.0%
Non-Operating Income/(Expenses)	60,308	12,977	47,331	365.7%
Income before Operating Transfer	\$ 6,222,555	\$ 8,115,602	\$ (1,893,047)	-23.3%
Transfer to General Fund	\$ (6,222,555)	\$ (8,115,602)	\$ (1,893,047)	-23.3%
Changes in Fund Net Assets	\$ 0	\$ 0	\$ 0	0

Powerball sales were down approximately \$3 million for fiscal year 2005 because of frequent wins and the resulting lower jackpots. Montana Cash, Wild Card II and Qwik Tix experienced small declines in sales, while Hot Lotto and scratch tickets increased. Direct Game Costs, which include prizes, operator fees, retailer commissions and scratch ticket printing, are directly related to sales and therefore also show a reduction.

Total Operating Expenses increased 5.5%. Individual expense categories varied slightly with both increases and decreases. Two increased expenses of note were Contracted Services and Supplies. The Lottery paid Batelle \$76 thousand under a contract evaluating the current operating system preparatory to soliciting bids for a new system in fiscal year 2006. The Lottery also purchased 700 lighted "Play Lotto Here" signs for display at our retail locations at a cost of \$104 thousand.

The income from Non-Operating activities increased from the previous year. This category includes interest received from investments, interest paid on the long-term loan and gains or losses on the sale of non-current assets. The long-term loan was paid in full in fiscal year 2004 and overall interest receipts of \$62,033 in fiscal year 2005 were greater than the \$43,986 received in 2004.

The decrease in sales and slight increase in operating expenses resulted in the Lottery transferring \$6.2 million to the General Fund.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

CAPITAL ASSETS AND DEBT ADMINISTRATION

The Lottery follows the State's policy of capitalizing long-term assets with an historical value of \$5,000 or more. The Lottery's capital assets are divided into three categories: 1) a fleet of vehicles used by the sales staff, 2) office or computer equipment, and 3) the lottery operating system, which tracks and controls the sale of all Lottery products, validation of winning tickets, and payments to winners. The operating system consists of centralized computer equipment and operating software located in Helena and includes all of the terminals (selling scratch tickets, Qwik Tix and lotto games) located at retail locations.

Capital assets are depreciated using the straight-line method over the appropriate estimated useful life, ranging from three to seven years.

In fiscal year 2005, the Lottery purchased a single replacement vehicle for \$17,994.

In 1999, the Lottery entered into a loan agreement with Norwest Investment Services to purchase the lottery system equipment and related software. The 5-year loan was for \$5,025,311 at 5.12% interest. This loan was completely satisfied in April 2004. The Lottery currently has no debt-related commitments.

LOOKING AHEAD

The Lottery's goal is to maximize revenue for the State's programs while maintaining the public trust in lottery gaming. This requires offering games that Lottery players want to play, providing convenient locations for the purchase, and controlling operating expenses.

The Lottery introduces new scratch games on a regular basis. In fiscal year 2005, 34 games featuring different graphics, play styles, and prize levels were introduced, including a *Star Wars* game and our first \$5 Crossword. Approximately, the same number of newly introduced games will be presented in fiscal year 2006. We plan to build scratch sales through innovative game themes and product advertising.

A Powerball matrix change is scheduled for August 2005 that is expected to increase jackpots and stimulate greater sales. The Lottery is also evaluating other games that will be offered through the Multi-State Lottery Association for their appeal to Montanans.

Qwik Tix has not been as successful as market research indicated. Therefore, the product line will be re-evaluated to determine if the product will continue, will need to be changed, or will be discontinued in the future.

In early fiscal year 2006, the Lottery will issue, evaluate and accept a Request for Proposal to replace the current lottery operating system, including all facets of equipment, ticket sales, validations, reporting and communications. This is necessary because the current contract with Scientific Games expires on March 30, 2006. The transition to the new system will require much work on the part of Lottery staff but is expected to result in an up-dated system that will serve our players' and retailers' needs at the least cost to the Lottery.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

LOOKING AHEAD, Continued

The Lottery will continue to look for opportunities to meet the expectations of our players for new and interesting games. We will also continue our efforts to increase the number of retail outlets throughout the state with new terminal placements or by upgrading current scratch-only retailers to full service locations to better serve our players.

Exceptional increases in lotto revenue are usually the result of higher jackpots; however, such jackpots cannot be predicted nor depended upon to occur at any specific time. Therefore, omitting the possibility of a record jackpot, the Lottery projects that the transfer to the General Fund in fiscal year 2006 will be approximately \$8 million.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of the Lottery's finances for all of Montana's citizens, taxpayers, players and creditors, and to report on the Lottery's accountability for its funds. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Montana Lottery, 2525 N. Montana Avenue, Helena, MT 59604.

Concluded

Montana State Lottery
STATEMENTS OF FUND NET ASSETS
June 30,

	<u>2005</u>	<u>2004</u>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	349,048	297,559
Accounts receivable, net of allowance	1,349,901	1,149,380
Due from primary government	9	1,039
Due from component units	321	707
Inventory	1,100,853	1,034,181
Other current assets	21,710	16,339
Total current assets	<u>2,821,842</u>	<u>2,499,205</u>
FURNITURE AND EQUIPMENT		
Furniture, fixtures and equipment	5,563,895	5,563,836
Accumulated depreciation	<u>(4,819,838)</u>	<u>(3,929,838)</u>
Total furniture and equipment	<u>744,057</u>	<u>1,633,998</u>
INTANGIBLE ASSETS		
Software, net of accumulated amortization	123,214	287,500
OTHER ASSETS		
MUSL Prize Reserve fund	<u>1,326,136</u>	<u>1,325,275</u>
TOTAL ASSETS	<u><u>5,015,249</u></u>	<u><u>5,745,978</u></u>
LIABILITIES AND FUND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	525,788	474,326
Estimated prize liability	1,436,459	1,528,838
Transfer obligations to general fund	1,526,239	2,188,861
Due to primary government	7,918	9,763
Due to component units	5	279
Deferred on-line revenue	100,634	63,777
Property held in trust	-	6,000
Current portion of accrued compensated absences	97,302	112,270
Total current liabilities	<u>3,694,345</u>	<u>4,384,114</u>
LONG-TERM LIABILITIES		
MUSL prize liability	1,257,803	1,283,395
Long-term portion of accrued compensated absences	63,101	78,469
Total long-term liabilities	<u>1,320,904</u>	<u>1,361,864</u>
TOTAL LIABILITIES	<u>5,015,249</u>	<u>5,745,978</u>
COMMITMENTS AND CONTINGENCIES		
FUND NET ASSETS		
Invested in capital assets, net of related debt	867,271	1,921,498
Unrestricted fund net assets	<u>(867,271)</u>	<u>(1,921,498)</u>
TOTAL FUND NET ASSETS	<u>-</u>	<u>-</u>
TOTAL LIABILITIES AND FUND NET ASSETS	<u><u>5,015,249</u></u>	<u><u>5,745,978</u></u>

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN FUND NET ASSETS
for the years ended June 30,

	<u>2005</u>	<u>2004</u>
OPERATING REVENUES		
Scratch ticket games	10,535,046	10,378,001
On-line games	23,276,199	26,359,656
Miscellaneous	31,405	2,543
Total operating revenues	<u>33,842,650</u>	<u>36,740,200</u>
DIRECT GAME COSTS		
Scratch ticket prize expense	6,275,935	6,199,677
On-line ticket prize expense	11,527,966	12,480,211
Retailer commission	1,965,321	2,090,986
On-line vendor fees	2,822,415	3,066,764
Cost of tickets sold	767,140	703,965
Total direct game costs	<u>23,358,777</u>	<u>24,541,603</u>
Income before operating expenses	<u>10,483,873</u>	<u>12,198,597</u>
OPERATING EXPENSES		
Advertising	606,394	634,098
Communications	91,550	89,904
Advertising production	145,435	127,767
Audit fees	22,333	43,335
Contractual services	266,639	190,357
Depreciation and amortization	1,069,530	1,064,432
Management fees	54,318	54,289
Multi-state operating fees	88,856	91,967
Other	52,271	38,770
Public relations	27,318	27,292
Personal services	1,455,722	1,400,905
Repairs and maintenance	24,822	17,685
Supplies and materials	273,593	192,913
Utilities and rent	111,067	108,720
Travel	31,778	13,538
Total operating expenses	<u>4,321,626</u>	<u>4,095,972</u>
OPERATING NET INCOME	<u>6,162,247</u>	<u>8,102,625</u>

Continued

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN FUND NET ASSETS
for the years ended June 30,

	<u>2004</u>	<u>2004</u>
NON-OPERATING REVENUES (EXPENSES)		
Interest income	62,033	43,985
Interest expense	-	(25,481)
Loss on disposal of furniture and equipment	(1,725)	(5,527)
Total non-operating net income	<u>60,308</u>	<u>12,977</u>
INCOME BEFORE TRANSFERS	6,222,555	8,115,602
TRANSFERS OUT		
General fund	6,222,555	8,115,602
Total transfers out	<u>6,222,555</u>	<u>8,115,602</u>
Fund net assets, beginning of year	<u>-</u>	<u>-</u>
Fund net assets, end of year	<u><u>-</u></u>	<u><u>-</u></u>

The accompanying notes are an integral part of these financial statements.

Concluded

Montana State Lottery
STATEMENTS OF CASH FLOWS
for the years ended June 30,

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from sales	33,671,604	36,736,154
Cash paid to suppliers for goods and services	(7,301,718)	(7,876,026)
Cash paid to employees	(1,464,055)	(1,391,042)
Cash paid for prizes	(17,974,108)	(18,504,635)
Net cash provided by operating activities	6,931,723	8,964,451
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES		
Transfers out:		
General fund	(6,885,178)	(7,738,012)
Net cash used by non-capital financing activities	(6,885,178)	(7,738,012)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of fixed assets	(17,994)	(38,840)
Interest paid	-	(21,536)
Payments on long-term borrowing	-	(1,124,042)
Proceeds from sale of fixed assets	3,386	1,039
Net cash used by capital and related financing activities	(14,608)	(1,183,379)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest and dividend income	19,552	9,766
Net cash provided by investing activities	19,552	9,766
NET INCREASE IN CASH AND CASH EQUIVALENTS	51,489	52,826
Cash and cash equivalents, beginning of year	297,559	244,733
Cash and cash equivalents, end of year	349,048	297,559
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	6,162,247	8,102,625
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	1,069,530	1,064,432
Changes in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(200,521)	99,308
Due from primary government	(9)	584
Due from component units	386	(707)
Inventory	(66,672)	(426,920)
Other current assets	(5,370)	14,631
Long-term receivable	(861)	417,368
Interest receivable included in long-term receivable	41,099	34,221
Increase (decrease) in:		
Accounts payable	51,462	9,287
Lottery prizes payable	(117,971)	(227,451)
Deferred revenue	36,857	(109,356)
Property held in trust	(6,000)	6,000
Due to primary government	(2,123)	(25,251)
Due to component units	5	279
Compensated absences payable	(30,336)	5,401
Net cash provided by operating activities	6,931,723	8,964,451

The accompanying notes are an integral part of these financial statements.

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - The Montana State Lottery (hereafter referred to as the Lottery) was created in November 1986 by a referendum vote of the people of Montana.

Section 23-7-101, Montana Code Annotated (MCA) establishes the provision of the code under which the Lottery operates. The Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the type and forms of lottery games, set ticket prices, determine the number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games with other states, and prepare financial reports. The Lottery is attached to the Department of Administration for administrative purposes.

Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The remaining revenue, less expenses, is transferred to the Montana State General Fund.

Reporting Entity - The Lottery is included in the State of Montana's financial statements as an enterprise fund. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Lottery's financial statements as a reporting agency.

Basis of Accounting - The Lottery utilizes the accrual basis of accounting and is classified as an enterprise fund of the governmental proprietary fund type. Enterprise funds account for operations similar to private business enterprises where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or where the Legislature has decided that periodic determination of revenue earned, expenses incurred or net income is appropriate.

Revenue Recognition - Sales of scratch lottery tickets are made to licensed retailers who market the tickets to the public on a commission basis. Revenue is recognized when tickets are activated by retailers. Tickets activated, but not sold by retailers, may be returned for credit. Sales are reduced for estimated ticket returns.

Sales of lotto tickets, Powerball, Wild Card, Hot Lotto and Montana Cash, are made through licensed retailers who market the tickets on a commission basis using computerized terminals. Revenue is recognized on drawing dates. Tickets sold in advance of future drawing dates are recorded as deferred revenue until the ticket becomes valid for a drawing. Qwik Tix revenue is recognized at the time of the sale by the retailer.

Cash and Cash Equivalents - Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investments pool, cash deposited with banks and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Allowance for Uncollectible Accounts - The Lottery uses the allowance method to account for uncollectible receivables. The allowance is based on management's estimate of possible bad debts.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

Advertising Costs - Advertising costs are expensed as incurred.

Allowance for Returned Tickets - The Lottery's policy is to accept any unplayed scratch ticket from a retailer for credit without regard to when the ticket or pack of tickets was activated. Therefore, an allowance to recognize the possibility of returns is calculated at the end of each fiscal year.

Inventory - Inventory consists of tickets and supplies. Ticket inventory includes scratch lottery tickets that are carried at cost using the specific identification method. Tickets are charged to cost of sales when activated. Unsold tickets are charged to cost of sales upon the end or cancellation of the related game. Supply inventory is carried at cost and expensed as used.

Prizes - Prize expense is recognized based on a predetermined prize structure for each scratch ticket and on-line game. Free tickets are recorded as a reduction in revenue and not as prize expense.

Unclaimed Prizes - Prizes for the lotto games, Powerball, Wild Card, Hot Lotto, and Montana Cash, must be claimed within six months after the appropriate draw date. Prizes for Qwik Tix must be claimed within six months of the sales date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The combined amounts of unclaimed prizes for online games were \$534,630 and \$1,063,705 and for the scratch games were \$251,551 and \$232,349 for the fiscal years ended June 30, 2005 and 2004, respectively.

Intangible Assets - Intangible assets consist of software and represents the unamortized cost of software purchased in 1999. This software had an original cost of \$1,150,000 and is being amortized over seven years.

Furniture and equipment - Furniture and equipment are recorded at cost. Donated furniture and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of furniture and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in nonoperating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to seven years. The Lottery conforms to the State of Montana capitalization threshold for recording furniture and equipment. This threshold is \$5,000.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Compensated Absences - State employees earn vacation leave ranging from fifteen to twenty-four days per year based on years of service. Vacation leave may be accumulated to a total not to exceed twice the maximum number of days earned annually. Sick leave accumulates at a rate of twelve days per year with no maximum accumulation. Upon retirement or termination, an employee is paid for 100 percent of unused vacation leave and 25 percent of unused sick leave.

Use of Estimates - The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE B - CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

	June 30,	
	2005	2004
Short-term investment pool	\$186,928	\$ 1,766
Cash on deposit with State Treasurer	151,970	285,643
Cash in revolving deposit account	10,000	10,000
Petty cash	150	150
	<u>\$349,048</u>	<u>\$297,559</u>

The Lottery participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. The bank balance of the revolving deposit account was \$54,676 and \$12,666 at June 30, 2005 and 2004, respectively, and was covered by federal depository insurance up to \$100,000. The carrying amounts reported in the Statements of Fund Net Assets for cash and cash equivalents approximate the fair market value.

NOTE C - INVESTMENT RISK DISCLOSURES

Effective June 30, 2005, the State of Montana implemented the provisions of Governmental Account Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. The Lottery participates in two investment pools: the Multi-State Lottery Association (MUSL) reserve accounts and the State of Montana's Short Term Investment Pool (STIP). There are four types of risk that must be disclosed. These risks are defined below followed by their applicability to each of the investment pools.

Credit risk is defined as the risk that an issuer to an investment will not fulfill its obligation, i.e., not make timely principal and interest payments.

Custodial credit risk is the risk that the Lottery would not be able to recover the value of the investment or collateral securities that are in the possession of an outside party in the event of the failure of that party.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE C - INVESTMENT RISK DISCLOSURES, continued

Concentration of credit is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

Multi-State Lottery Association

The MUSL investment policy for prize reserve and unreserved funds states that permitted investments "include direct obligations of the United States government, perfected repurchase agreements, and obligations issued or guaranteed as to payment of principal and interest by agencies or instrumentalities of the United States government, and mutual funds of approved investments". Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk nor concentration of credit risk per GASB Statement No. 40.

The securities are held in trust for MUSL by Mellon Trust. This large diversified institution has several national offices, with the Everett, Massachusetts office handling the MUSL account. Interest rate risk is minimized by requiring that the average portfolio maturity be no more than 1.33 years and that the maximum maturity for any one security cannot exceed 5 years.

Short-term Investment Pool

All short-term funds are held in the State's Short Term Investment Pool (STIP) administered by the Board of Investments (BOI). A summarized description of their disclosure follows and full details may be obtained by contacting the Montana Board of Investments, 2401 Colonial Drive, P.O. Box 200126, Helena, MT 59620-0126.

For STIP securities, BOI's policy to manage credit risk requires securities have the highest investment grade rating in the short term category by at least one a Nationally Recognized Statistical Rating Organization (NRSRO). The six NRSROs include Standard and Poors, Moody's, Duff and Phelps, Fitch, IBCA and Thompson's Bank Watch.

Per the BOI, all STIP securities are registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank. The STIP investment policy does not specifically address concentration of credit risk. As of June 30, 2005 there were no single issuer investments that exceeded 5% of the STIP portfolio. Per GASB Statement No. 40, interest rate disclosures are not required for STIP since STIP is a 2a-7-like pool.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE D - ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	June 30,	
	2005	2004
Accounts receivable	\$1,442,990	\$1,265,171
Allowance for returned tickets	(93,089)	(115,791)
	<u>\$1,349,901</u>	<u>\$1,149,380</u>

NOTE E - INVENTORY

Inventory consists of the following:

	June 30,	
	2005	2004
Scratch tickets	\$ 969,756	\$ 974,820
Supplies	131,097	59,361
	<u>\$1,100,853</u>	<u>\$1,034,181</u>

NOTE F - OTHER CURRENT ASSETS

Other current assets consist of the following:

	June 30,	
	2005	2004
Prepaid expenses	\$19,960	\$11,539
Employee travel advances	1,750	4,800
	<u>\$21,710</u>	<u>\$16,339</u>

NOTE G - FURNITURE AND EQUIPMENT

A summary of furniture and equipment for the Montana Lottery is as follows:

	June 30,			June 30,
	2004	Additions	Deletions	2005
Furniture, fixtures and equipment	\$5,563,836	\$ 17,994	\$(17,935)	\$5,563,895
Accumulated depreciation	(3,929,838)	(905,246)	15,246	(4,819,838)
Total	<u>\$1,633,998</u>	<u>\$(887,252)</u>	<u>\$ (2,689)</u>	<u>\$ 744,057</u>

NOTE H - MULTI-STATE LOTTERY ASSOCIATION (MUSL)

Joint Venture Association - In November 1989, the Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. The Powerball game, Wild Card game and Hot Lotto game are presently the only games operated jointly by the members in which the Lottery participates. Each lottery participating in MUSL is represented on the Board of Directors.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE H - MULTI-STATE LOTTERY ASSOCIATION, continued

Prize Reserve Fund Receivable/Payable - As a member of the MUSL, the Lottery is required to contribute to various prize reserve funds maintained by MUSL. The contributions are to be used to fund unanticipated prize claims. All funds remitted and the related interest earnings will be returned to the Lottery upon leaving the association, less any portion of unanticipated prize claims, which was paid from the fund.

The Lottery contributes to the reserve fund through the set-aside for prizes. Payments made to the reserve fund are considered a portion of the prize expense associated with each game.

During 1990, the MUSL Board created the unreserved accounts to record interest earned on the various prize reserve funds when the prize reserve fund balance is not below the predetermined ceiling amount. The amounts in the unreserved accounts may be used at the Board's discretion.

The long-term receivable balance of \$1,326,136 and \$1,325,275 at June 30, 2005 and 2004, respectively, represents the Lottery's share of the MUSL prize reserve fund that had a balance of \$112,466,060 and \$104,926,824 for 2005 and 2004, respectively. The long-term liability balance of \$1,257,803 and \$1,283,395 at June 30, 2005 and 2004, respectively, represents the Lottery's share of the total estimated prize liability.

Lotto*America Prizes and Investments - Prizes awarded to Lotto*America grand prize winners are paid in twenty annual installments funded by investments in United States Treasury zero coupon bonds. Bonds purchased on behalf of Montana source winners are held in trust by MUSL with the Montana State Lottery as beneficiary. As the bonds mature, the proceeds are forwarded to the Lottery and distributed to the grand prize winners on the anniversary date of each win.

At June 30, 2005 and 2004, MUSL held United States Government zero coupon bonds in trust for the Lottery winners with respective par values of \$39,541,949 and \$44,749,941 and respective market values of \$34,059,006 and \$37,331,863.

The Lottery has eight Lotto*America/Powerball/Tri-West winners. The combined total future prize payments owed is \$39,676,000 and \$44,884,000, at June 30, 2005 and 2004, respectively. The present value of future prize payments approximates the current market value of the bonds held in trust for the Lottery winners.

Total annual payments due as of June 30, 2005 are:

2006	\$ 5,208,000
2007	5,208,000
2008	5,208,000
2009	5,208,000
2010	5,106,000
Thereafter	<u>13,738,000</u>
	<u>\$39,676,000</u>

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS June 30, 2005 and 2004

NOTE H - MULTI-STATE LOTTERY ASSOCIATION, continued

Multi-State Lottery Association Financial Position - Information related to the Multi-State Lottery Association's audited financial statements is as follows:

	June 30,	
	2005	2004
Total assets	<u>\$1,138,781,518</u>	<u>\$1,202,963,173</u>
Total liabilities	1,138,555,856	1,202,740,173
Total net assets	<u>225,662</u>	<u>223,000</u>
Total liabilities and net assets, unrestricted	<u>\$1,138,781,518</u>	<u>\$1,202,963,173</u>
Total revenues	\$ 3,520,580	\$ 5,910,374
Total expenses	<u>3,517,918</u>	<u>5,972,508</u>
Increase (decrease) in unrestricted net assets	<u>\$ 2,662</u>	<u>\$ (62,134)</u>

NOTE I - ESTIMATED PRIZE LIABILITY

The estimated prize liability represents the Lottery's estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

NOTE J - OBLIGATION TO TRANSFER FUNDS

The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB 83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. Transfer obligations outstanding at June 30, 2005 and 2004 were \$1,526,239 and \$2,188,861, respectively.

NOTE K - LONG-TERM LIABILITIES

Long-term liabilities consist of the following:

	June 30,			
	Current	Long-Term	2005 Total	2004 Total
Prize liability Multi-State Lottery Association	\$ -	\$1,257,803	\$1,257,803	\$1,283,395
Accrued compensated absences	<u>97,302</u>	<u>63,101</u>	<u>160,403</u>	<u>190,739</u>
	<u>\$97,302</u>	<u>\$1,320,904</u>	<u>\$1,418,206</u>	<u>\$1,474,134</u>

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE L - LEASES

The Lottery leases its office, administrative and warehouse facilities under a non-cancelable lease agreement that is effective March 2002 through February 2007. Rent expense under operating leases charged to operations was \$88,332 and \$87,520 for the years ended June 30, 2005 and 2004, respectively.

The Lottery also has an operating lease for office equipment, primarily the photocopier, with monthly payments of \$428, which expired August 2005. Rental expenses for these leases consisted of \$5,142 and \$5,142 for the years ended June 30, 2005 and 2004, respectively.

Future minimum lease payments under operating leases that have remaining terms in excess of one year as of June 30, 2005 are:

Years ending June 30:

2006	\$91,849
2007	61,964
2008	-0-
2009	-0-
2010	-0-

NOTE M - EMPLOYEE BENEFIT PLANS

Pension Plan - The Lottery participates in the Public Employees Retirement System (PERS). PERS is a statewide mandatory cost-sharing multiple employer retirement plan which covers all employees. The plan is established under State law and is administered by the State of Montana. The plan provides disability and death benefits to plan members and beneficiaries as well as a choice of a defined benefit or a defined contribution retirement plan.

The plan issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained from the following address: Public Employees Retirement System, Montana Public Employees Retirement Administration, P.O. Box 200131, 100 N. Park, Suite 220, Helena, MT 59620-0131, (406) 444-3154.

The contribution rate for the plan is required and determined by State law. The contribution rate for fiscal years 2005 and 2004, expressed as a percentage of covered payroll, was 6.9% for both years, for both the employer and the employees.

The amounts contributed to the plan during the years ended June 30, 2005 and 2004, were \$155,684 and \$147,506, respectively, and were equal to the required contributions for each year.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE M - EMPLOYEE BENEFIT PLANS, continued

Deferred Compensation Plan - The Lottery's full-time regular employees are eligible to participate in the State of Montana's deferred compensation plan. The plan is administered by Benefits Corporation on behalf of Great West Life Insurance Company through a contract with the State of Montana. The amount of compensation deferred is not available to employees until termination, retirement, death, or unforeseen emergency. All amounts are deferred under the plan created under Internal Revenue Code Section 457 and Title 19, chapter 50, Montana Code Annotated (MCA). Assets of the deferred compensation plan are required to be held in trusts, custodial accounts or insurance company contracts for the exclusive benefit of participants and their beneficiaries.

NOTE N - RELATED PARTY TRANSACTIONS

During the ordinary course of business, other State agencies provide certain services and supplies to the Lottery. During 2005 and 2004, total payments to other State agencies were approximately \$168,783 and \$212,750, respectively.

NOTE O - COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENT

Scratch Tickets - The Lottery has an agreement with Oberthur Gaming Technologies Corp. to print scratch game tickets. The contract expires August 8, 2008. The Lottery incurs approximately \$750,000 per year under this contract.

On-line Vendor - The Lottery is contracted with Scientific Games International to provide for the operation of an on-line gaming system through March 30, 2006. The estimated total contract price is approximately \$24 million over the seven-year contract.

Subsequent Event - On-Line Vendor - The Lottery entered into a contract with Intralot USA in October 2005 to provide on-line gaming services for the period March 31, 2006 through March 30, 2013. The contract price is 5.8% of each \$1 ticket sold, which is a reduction from 8.35% charged under the existing contract. The new contract price includes the cost of equipment. Unsuccessful bidders may challenge the award. As of the date of these financial statements, no challenges were filed.

Advertising - The Lottery signed a contract with Banik & Associates to provide advertising services for \$5,500 per month through December 2006.

Independent Observation of Drawings - The Lottery is committed to Galusha, Higgins and Galusha, PC, to observe Montana Cash and other special drawings. The term of the contract is for three years ending June 30, 2005. Compensation will not exceed \$25,000 for the three year period. The contract was renewed for a three year period ending June 30, 2008. Compensation under the new agreement will not exceed \$30,000.

Audit of Financial Statements - The Lottery is party to a contract with Galusha, Higgins and Galusha, PC, an independent accounting firm, to audit the Lottery's annual financial statements. The yearly contract was finalized on December 12, 2002, and is renewable annually for two additional years with the consent of all parties. Compensation for the years ended June 30, 2005 and 2004 will not exceed \$12,000.

Continued

Montana State Lottery

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE O - COMMITMENTS AND CONTINGENCIES, continued

Prize Contingencies - Certain Big Spin prizes awarded are payable to the winners in annual installments spanning seventeen to twenty years with the first payment being made by the Lottery. The Lottery has entered into agreements with an insurance carrier under which purchased annuities will provide the required level of payments corresponding to the Lottery's obligation to these prize winners. Because it is the intent of the Lottery that the insurance carrier will make future installment payments directly to each prize winner, neither the present value of the annuities nor the present value of the future payments are reflected in the accompanying financial statements. The Lottery would be liable for such future payments in the gross amount of \$435,000 and \$697,500 at June 30, 2005 and 2004, respectively, if the insurance carrier defaulted on their payments.

NOTE P - RISK MANAGEMENT/PUBLIC ENTITY RISK POOL

The Lottery contributes to the Group Employee Comprehensive Medical and Dental Plan and the Property and Casualty Insurance plans of the State of Montana. Details of these plans can be found in the State of Montana Comprehensive Annual Financial Report.

Concluded

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND
OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE
WITH *GOVERNMENT AUDITING STANDARDS*

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the financial statements of Montana State Lottery (Lottery), an enterprise fund of the State of Montana, as of and for the year ended June 30, 2005, and have issued our report thereon dated October 7, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

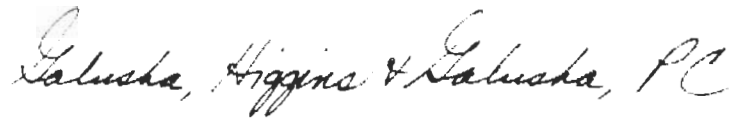
In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

To the Commissioners
Montana State Lottery

This report is intended for the information of the Lottery's Commissioners, management and the Legislative Audit Committee and is not intended to be and should not be used by anyone other than those specified parties.

A handwritten signature in cursive script that reads "Galusha, Higgins & Galusha, PC".

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
October 7, 2005